TEACHERS' RETIREMENT SYSTEM OF THE STATE OF ILLINOIS
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Opening Remarks on the TRS Assumed Rate of Investment Return
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Since what we are about to discuss has attracted widespread attention, I would like to share some background for the benefit of the trustees who are new to the board, as well as for those who have been on for a while but for whom the annual valuation process will be new.

While some seem to think otherwise, nothing we are considering today is precipitate or rushed. We are following well established procedures that are consistent with good actuarial practice and conform to the recommendations of the state actuary. The the annual review of the assumed rate of return is timely and necessary. It is a process that we have done annually in recent years, consistent with the recommendation of the state actuary. We made no changes in 2013 or 2015 and dropped the assumed rate in 2012 and 2014, each time by 50 basis points to its current 7.5% level.

The decisions that the board makes today are necessary for Segal to complete their work on the actuarial valuation that must be presented to you at the October meeting. At the October meeting, based on the results of the valuation, you must certify on a preliminary basis the required state contribution for FY2018. The valuation must then be delivered to the state actuary prior to November 1st for their review. Once the state actuary completes their review, they will either concur or note any required changes and the board will then finalize the certified contribution and deliver it to the Governor and the legislative leadership. This will likely occur early in 2017.

For those who do not know, the state actuary reports to the Auditor General. The office was created by the General Assembly several years ago to provide a review of the assumptions, practices and valuation work of the actuaries retained by the various state funded systems. The work and the assumptions used by our prior actuaries always was found up to standard and we have never had to change the results of the valuation after the state actuary concludes its review. I do not expect that to change this year.

It is important to remember that the TRS board is a fiduciary board, not a policy setting board. Policy is reserved to the General Assembly. They are the body politic that created and is the sponsor of the pension plan. Our fiduciary duty requires that we must do what is best for the financial sustainability of the plan, within the current statutory construct. If the General Assembly sees fit it can, and has, revised the statute to address current political realities. We are all too familiar with years where the statutory funding amount has been cut or a decision of the board has been overridden with the passage of legislation. An example of the latter is when the board's decision to lower the pension contribution rate for federally funded teacher salaries was reversed and the policy is now dictated by statute.

If the General Assembly does not agree with a fiduciary decision made by the board that increases the state's required contribution it certainly can override the decision by legislation. That is similar to what happened with the enactment of Tier II when the board was required to re-certify the FY2011 contribution at my first board meeting in January 2011, more than half way through the fiscal year.

Contrary to what some have opined there has been no opportunity for politics to come into play. This is a staff led process. To suggest that politics have intervened is offensive to me personally and anathema to the way that TRS is governed. Seeking to put off any change the board may adopt today reflects a misunderstanding of the board's role and our fiduciary responsibility. It will surely be noted by the state actuary as a failure to follow good actuarial practice and the recommendations of our independent actuary. It would inject politics into our governance; the kind of politics that has created the funding shortfall we face today. Our new trustees should be aware that TRS has never once in its history received an annual contribution from the state that was actuarially adequate.

As I noted early on in my tenure political science has always trumped actuarial science in Illinois. It continues today with the "Illinois math" of our statutory funding formula. Personally, I would go further than what is up for consideration today and suggest, as I have in various legislative hearings, that we become fully transparent in our funding calculations. The board already certifies the true actuarial required contribution along with the statutory calculation. The proper policy would be to have the calculation of an actuarially based contribution required by statute.

That would end the charade of people feeling good about paying an artificially low contribution each year. If the state can only afford some lower amount then so be it, but at least everyone will know the real picture.

Requiring full actuarial funding calculations would raise the risk that opponents of TRS and defined benefit plans generally will use those higher but more accurate annual contributions to characterize TRS as unsustainable. We have to remember that Illinois is the exception, not the rule. Those who don't like or merely don't understand defined benefit plans either willfully or ignorantly ignore the fact that when funded as designed, crippling funding shortfalls don't occur. Between sixty and seventy percent of the cost of the benefit is designed to be borne by investment earnings over the life of the member. It is only when you don't have the money to invest that the cost becomes unbearable. Taxpayers have to pay for those lost earnings and that reality has been documented fully and writ large in Illinois. It is not plan design that has failed, it is politics.

Yet, while the virtues of a defined benefit plan like TRS are there to be realized, the math is unforgiving and the financial benefits fall apart when the funding does not occur as designed. The truth is simple. More contributions now means lower required contributions later. Lower contributions now means higher, and often much higher, contributions over the long run. ***Putting off the pain does not change the reality of what it costs to properly fund the benefits. It only increases it.***

It seems to me what is occurring is that after years of TRS making the point, everyone is realizing that our funding status is seriously bad. You cannot avoid the harsh reality. While the threat of our funding shortfall to benefit checks remains well out in the future, the decisions required to avoid that calamity are immediate. To that end, and especially since we have many trustees who are new to TRS, I have asked Segal to provide additional analysis of our funded status when they present the FY2018 valuation results in October. As we first did in 2012, that could include preparing insolvency scenarios and other additional information beyond the required solvency charts in the valuation. It is critical that the entire board fully understand the depth of the challenge that we face. The longer it takes for solutions, the more painful and expensive those solutions become.

So that the board and the public are clear, regarding today's decision you have three options. Upon hearing and discussing Segal's recommendation you can adopt it as presented. That will increase the state's required contribution to TRS in FY2018. You can choose to do nothing and keep the rate the same. The state's contribution may still go up under the statutory pension contribution schedule, but likely not as much. Or, you can approve another rate of return. A higher rate reduces and any lower rate increases the state's required contribution.

I could argue today that we would be justified in doing more than is recommended by Segal and approve an assumed rate of return lower than 7%. However, I am comfortable accepting their recommendation because this is just the first bite at the apple. As you know, we will be conducting a full asset allocation review during the year that will be presented at our board retreat in April and adopted at the May meeting of the board. A critical element of that work will be to revisit our capital markets assumptions. Allowing our established process to play out will allow us to more fully analyze the factors that many, including me, believe will point us to an even lower expected return.

I hope this background is helpful. I am happy to answer questions before Segal presents.